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No one incident unites both contradiction and slowing effectively as a stock market crash. A stock market crash wipes out great masses of credit currency with unusual suddenness; and, at the same time, it so stirs the cautious side of human nature that men hang on harder than ever to their available money.

Booms Depression, Irving Fisher,
Adelphi Company, New York 1932

DIRTY, LITTLE SECRETS

How strong is the U.S. economy? It is our long-held view that another question is more appropriate: How vulnerable is the U.S. economy? America's stock market bubble is of a magnitude without precedent in history. It encompasses the entire economy, and its effects on the economy are so pervasive and so ingrained that when the bubble bursts, there will be trouble in every corner of the economy and the financial system.

True, the U.S. economy is booming. However, as this letter will show there is a lot of statistical fudge in the GDP and productivity numbers. A substantial part of their stellar growth rates is purely statistical in origin. These effects are what we call the "dirty little secrets."

What disturbs us most is the immensity of credit and debt injections that the U.S. economy guzzles in order to keep performing. Unprecedented debt creation has created unprecedented illiquidity and a highly precarious boom.

A CARICATURE OF "CLASSIC" ECONOMICS

Capitalism is about profits. Strictly speaking: The Primary purpose and motive of all business activity under the capitalist system is not to produce goods, but to produce profits. It has been the basic tenet of "classic" economics that the pursuit of profit by the individual entrepreneur, orchestrated by the invisible hand of free markets, maximizes collective prosperity.

Sounds like American "new era" vocabulary, doesn't it? Actually, this specific, antagonistic character of the capitalist economy was first emphasized a hundred years ago by a Russian economist, Michael Tugan-Baranowski (*Theorie und Geschichte der Handelskrisen in England*, 1901). Emphasizing the vital importance of profits and investment spending as the key determinants of the business cycle and economic growth, he crucially influenced economic thinking across all schools of economic thought in Continental Europe, from the Austrians to Keynes.

Though Keynes gained his fame by advocating government spending as the cure for economic weakness, his economics is the outgrowth of this Continental development, stressing the pivotal role of profits in driving and powering economic growth in a capitalist economy through its influence on investment spending:

"We live in a society organized in such a way that the activity of production depends on the individual businessman hoping for a reasonable profit, or at least, to avoid an actual loss. The margin which he requires as his necessary incentive to produce may be a very small proportion of the total value of the product. But take this away from him and the whole process stops."

This development of the theory of investment spending and its key role in income creation was largely overlooked by English-speaking economists until it became incorporated as a basic cornerstone of the

Keynesian theory. American economists, however, have never fully accepted this European investment theory. Their thinking continues to be largely shaped by a notion that evolved in America during the 1920s. It says - we quote from a famous book of the time - "the one thing that is needed above all others to sustain a forward movement of business is enough money in the hands of the consumers."

"The New Economy is built on old virtues: thrift, investment and letting market forces operate," says U.S. Treasury Secretary Lawrence S. Summers. If so, the new American model might well be called the rebirth of classic economics. But where in the new American economy is the thrift? In the capital gains of the stock market stoking egregious consumer profligacy? With this feature, the new American model is but a caricature of the classic model. While the old economists focused on profits, savings and investment spending as the crucial growth fundamentals, the new American model focuses on shareholder value and nothing else. This "nothing else" is the most important point to see.

The fact is that the obsession with stock prices has completely distracted attention from the underlying corporate and economic fundamentals that make for profitability and prosperity in the long run. Typically, nobody cares how the higher share prices come about, whether through new investment, cost-cutting, stock buybacks, diverse accounting tricks, rampant money and credit creation or mere propaganda. Nothing but their rise is of interest. Frankly speaking, this is corporate thinking at its lowest.

Internet stocks have been the wonder of the most recent stage of the bull market. Their owners have made fortunes overnight. The great irony, though, is that only a handful of them makes actual profits. For the most part, even the well-established Internet companies are running expenses so grossly in excess of their revenues that profits can't be expected for many years to come.

In an unholy alliance with the great majority of Wall Street analysts, the loss-making managers of Internet firms have peddled the bull story that any losses should be regarded as investments in the future with apparent, smashing success. Selling below costs, so according to this argument, serves to capture increasing market shares that will, later on, deliver astronomic revenue and profits justifying the exorbitant prices that investors are now paying for such companies. Year after year, however, the records show diminishing, not rising, returns, despite soaring revenues.

THRIVING ON LOSSES

In early February, Amazon.com, the leading proponent of losing money on the Internet in order to fuel rapid growth, announced a loss of \$323 in the three months to Dec. 31, far more than expected and 543% more than the loss in the quarter a year earlier. Losses for the whole year amounted to \$700 million on total sales of a little more than \$1,600 million. And what happened to the stock price? Charmed by management's euphoric comments, investors boosted it from \$69 to \$80 in a single day.

In the year before, by the way, the company had lost about \$100 million on sales of about \$600 million. On every dollar of sales, Amazon had lost 16.7 cents. In the fourth quarter of 1999, the recorded loss of \$323 million compares with sales of \$676 million, implying a loss of almost 47.6 cents on every dollar of sales. New Economy, new capitalism?

Just two months earlier, in early December 1999, an analyst of J.P. Morgan had published a buy recommendation on Amazon's stock. Within hours, the stock price soared 40%, reaching its all-time high of several months prior. A week and a half later, Jeffrey Bezos, Amazon founder and CEO, was named *Time* magazine's Man of the Year.

To say the obvious: Internet retailing, although exploding in quantity, proves a profit disaster. What's more, it's getting dramatically worse, not better. Apparently, the hotly anticipated Christmas selling season did turn out to be a fiasco for most Internet retailers, as they drowned each other out with frenetic advertising that cost

buckets of cash. EToys, for example, spent \$ 66 million on marketing and sales alone to generate revenue of \$107 million.

No question, the advancements in information technology are extraordinary. Yet, as we have repeatedly stressed, we should beware of confusing technological advance with ability to generate profits and national wealth in terms of productive capital stock, incomes, productivity and profits.

Paraphrasing an ironic remark made some years ago by Robert Solow, a Nobel laureate in economics, about computers and missing productivity growth, we are tempted to say: You can see the computer age everywhere these days except in business profits." If it were really true that the new technology is feeding extraordinary productivity gains, then corporate earnings ought to be soaring. Indeed, that's the belief in the market.

Nevertheless, this perception of booming profits is pure chimera. According to the official National Income and Product Accounts, non-financial U.S. corporate profits peaked more than two years ago, in the third quarter of 1997. Since then, domestic profits in the non-financial sector have been going nowhere. In the manufacturing sector, they are even sharply down.

Definitely, this poor profit trend grossly contradicts the postulated, great productivity miracle, implying lately even declining unit labor costs lately. How can this striking contradiction be explained?

Economic growth is persistently surprising on the upside: recorded annual productivity growth has more than doubled in the last two to three years to almost 3%; unemployment has all but disappeared, and inflation remains nevertheless subdued. The best of all possible worlds.

WHAT IS REALLY UNIQUE?

Nevertheless, from what we read and hear, there seems to be a spreading apprehension that many features of this development are ominously reminiscent of the boom of the 1920s; Even *Business Week* carried a story: The Risk that Boom will turn Bust. In essence, for sure, there are many striking parallels. Yet there is something unique about this U.S. bubble and bubble economy: its unprecedented magnitude. It is by all accounts the biggest and the worst bubble in history and it has fueled economic and financial imbalances of unprecedented scale.

Consider this: In the 1920s, the U.S. economy actually did possess excellent economic fundamentals. The United States was the world's greatest creditor endowed with a substantial surplus in domestic savings and foreign trade. Against the backdrop of 4% annual productivity growth, inflation was not just low, but zero for years. And how do these features look today? Every one compares miserably. The world's former, greatest creditor is now the world's greatest debtor, running a monstrous current-account deficit, while domestic savings have almost vanished.

What explains this phenomenal difference? In brief, the credit excesses of the 1990s vastly exceed those in the 1920s. Credit excesses can and ought to be measured by two gauges: first, economic activity, as measured by GDP growth; and second, available current savings. By both gauges, the U.S. credit excesses of recent years defy imagination and historic comparison. Over the last 12 months, total credit has expanded by well over \$2,000 billion. That was about five times the simultaneous GDP growth and about 10 times available domestic savings. Perfectly in line with this preposterous scale of the credit excesses are the unprecedented valuations in the stock market. In the 1920s, this credit-to-GDP ratio was at its peak 2.2:1. Currently, it is 5:1. Average stock valuations are more than three times their level in late 1929, more than 10 times for stocks of high tech firms.

EFFECTS OF INFLATION

In its latest *World Economic Outlook*, published last October, the International Monetary Fund argues that conventional inflation can sometimes be a poor gauge of whether an economy is overheating and urges central

banks to pay more attention to other signs of imbalance, such as rising asset prices, rapid credit growth, private-sector financial deficits and current-account deficits. The IMF suggested that overheating asset markets might call for monetary tightening not only when it threatens an increase in product-price inflation, but also when asset prices increase to unsustainable levels that threaten to destabilize the economy.

Such statements find little sympathy in the United States. Mr. Greenspan's speeches as well as the public discussion betray a complete lack of understanding of this concept of imbalances caused by credit excesses, articulated in particular by Austrian theory. It says that credit excesses have their most dangerous effects not in rising price indexes, but in calling forth, *first*, unsustainable economic imbalances and dislocations, *second*, overvaluations of assets and, *third*, over-indebtedness. Rather, the prevailing attitude about inflation is one of absolute simplicity: The one and only thing that is supposed to matter in the American model is a rising price level, as measured by the conventional price indexes.

While Mr. Greenspan has personally declared that the booming stock market may account for one-fourth of recent real U.S. GDP growth, he has kept his eyes closed to the fact that this kind of effect is precisely what makes the ill-fated essence of a bubble economy - unsustainable wealth effects fueling unsustainable demand for goods.

When the bubble bursts, its existence becomes dramatically visible. But the view, as also expressed by Mr. Greenspan, that bubbles are not recognizable before they burst is grossly at fault. The fact that most economists readily agree with him is hardly astonishing. Nobody wants to stop a bubble. It also inherently implies general advance acquittal for failure to have seen it coming.

BUBBLE ANATOMY

Frankly speaking, this opinion reveals a frightening ignorance of what used to be accepted, elementary insight in economics across all schools of economic thought. The cause of this American boom is exactly the same that has powered all booms in history - excessive credit expansion. Stop that, and the bubble stops. But what is excessive credit expansion? The old economists had an equally simple and precise answer: available savings. They set the limit. Any lending without corresponding savings ranks as inflationary credit.

Worldwide credit flows in the 1990s underwent two striking changes. On the one hand, they widened dramatically; and on the other hand, the thrust of these flows shifted away from the GDP towards the financial markets outside of the GDP. In consequence, the inflationary pressures concentrated in the financial markets, primarily in the stock markets. A conspicuous symptom of this development was global credit growth in unprecedented excess of economic activity and savings. Skyrocketing stock prices became the global pattern. Still, substantial differences in the extent of credit excesses and stock valuations between countries should not be overlooked. The figures show the U.S. economy is by far the worst and the most extreme case.

When stock market gains are equated with savings, some elementary knowledge in economics is apparently missing. By heavily buoying consumer borrowing and spending, the wealth effects which the stock market in the United States poured over private households fostered massive dissaving, the very opposite effect of saving. Remember the quote on the first page: Capital decreases when the community consumes more than it produces.

Hayek would say, proper interpretation of numbers depends on proper theory, and that is apparently in very short supply today. Saying this, we have the fabulous stock market wealth effects in mind. The other day somebody called them the New Wealth of Nations. Adam Smith, who developed his economic theories in a book under this title, must be turning in his grave.

FICTITIOUS WEALTH

We come upon another piece of great importance. It's the distinction between *personal* and *national* wealth. What's the difference? Take the example of government bonds. For their owners, without question, they

represent wealth, *personal* wealth. Still, they don't represent *national* wealth because financial assets add nothing to the productive capacity of the community. The owners of government paper receive interest rates matched by tax payments. For the economy as a whole, there is no net income gain, only a transfer of purchasing power. The two cancel each other out.

Precisely the same principle applies to the wealth creation via rising stock prices. It is wealth for the stockowners, for sure, but not for the nation. But from a macroeconomic perspective, and in the vernacular of old economy, stock market wealth effects are but fictitious or imaginary paper wealth because the rising valuations add absolutely nothing to the productive resources of the community, on which the growth of national prosperity depends.

What's worse, to the extent that increasing stock market wealth fuels higher consumer spending - which it does in the United States - it implies capital consumption; in other words, it decreases national wealth. What the stockowners are in reality accumulating are claims on existing resources.

For decades, the U.S. economy has been ill-reputed for its low savings ratios. Thanks to Mr. Greenspan's overly loose monetary policy, this has gone from bad to disastrous in the last few years. Personal savings are approaching extinction while foreign indebtedness is outpacing domestic net investments. Take the rampant wealth creation via the stock market as what it is, creation of fictitious wealth, and you have a country that is living grossly beyond its means. Mises would call it an overconsuming economy on the road to impoverishment.

PRODUCTIVITY SURPRISE

For the faithful believers in the miracles of the U.S. new paradigm economy, it was definitely great news when the Labor Department recently announced that productivity per worker and hour in the fourth quarter of 1999 had soared at its quickest pace in seven years. Not only that, it matched the revised results for the previous three months. For all of 1999, productivity has increased 2.9%. Prior to 1973 U.S. labor productivity growth averaged in excess of 2% for as far back as the end of World War II. From 1973 to 1995 it fell to an annual average of 1.15%. Then, over the 1996-99 period, productivity growth in the nonfarm business sector abruptly recovered to an average of 2.8% per annum, actually the highest rate in the postwar period.

Has the predicted dramatic breakout of the U.S. economy to sustained, considerably higher productivity growth arrived? And even at a rate of 5%? Yes, it took us, too, by surprise. But what surprised us most of all was, how readily this number was immediately and generally accepted despite its glaring incompatibility with the big employment gains recorded by the Labor Department for the same quarter: 800,000 new jobs, annualized 3.2 million. With real GDP growth of 5.8% and productivity growth of 5%, both at annual rate, the minimal difference between the two essentially implies a trivial increase in labor input.

Before digging a bit deeper into the numbers, a brief reminder may seem in order: America is the only country in the world where GDP and related data are presented in annualized rates. That is, quarterly figures are quadrupled. In the rest of the world, the same figures are regularly presented in simple numbers, generally accompanied with a comparison year-over-year. Though both methods are correct, they certainly tend to generate quite different impressions. The U.S. economy's stunning growth rate of 6.9% in the fourth quarter, for example, would have been expressed in the rest of the world in a way that would hardly have aroused sensation: 1.7% growth quarter-over-quarter and 4.5% year-over-year. The upward revision from 5.8% now implies productivity growth of 6%.

We are convinced that sufficient readers, also in the financial press, tend to overlook this visual difference in the statistical presentation. Considering the great attention nowadays accorded to them, it seems sure that it actually influences perceptions. At any rate, we have noted that the media in general simply bring the published numbers without hinting at the existing differences in statistical measurement and presentation.

The productivity numbers, annualized or not, are unquestionably the most sensational among all the U.S. data. For Mr. Greenspan and many others, the cause of this “miracle” is self-evident: new information technology and unprecedented efficiency of American corporate management inspired by the idea of maximizing shareholder value are finally impacting the economy in full force.

In view of the overriding importance of this issue, we shall explain in some detail that this productivity miracle is just another myth that has far more to do with changes in the statistics than with changes in the economy.

Let's start with basics: Productivity, or labor productivity to be exact, is simply the increase in total output, as measured by real GDP, divided by the increase in total hours of labor employed to create that output. In short, the productivity growth rates result from a comparison of the increase in total output in goods and services with the increase in total labor input. In other words, everything depends on the precision in the changes of these aggregates. The dirty little secret of the alleged new paradigm miracles is that they are pure statistical fiction.

STATISTICAL FUDGE

We have already pointed out one striking oddity: the unbelievable discrepancy between the big monthly payroll numbers and the minimal growth in labor input underlying the productivity figures. They apparently draw on two different surveys: a monthly survey of large firms and a monthly survey of private households. The two surveys have always produced different estimates of employment growth. In the first half of the 1990s, they diverged on average by 0.4% annually. But this divergence has been increasing, and in the most recent quarters, it was fully 1%. By this account, this should explain at least 2 percentage points of the annualized productivity growth of 5%. But there is a lot more statistical fudge. It results from tinkering with the inflation data and the GDP deflator, which is used to derive real output growth (GDP in chained dollars) from the growth in current dollars. With growth in hours worked unchanged, any lowering of the GDP deflator essentially entails commensurate increases in the measure of real GDP growth and, implicitly, also in the measure of productivity growth. Together, these changes in the inflation statistics in recent years have substantially contributed to U.S. GDP and productivity growth.

The last such revision took place in 1996 in response to the recommendations of the Boskin Committee. In its final report, the Commission intimated that the existing CPI was overstating the actual rate of inflation by about 1.1 percentage points per year. It is officially estimated that the changes which the Labor Department put in place have removed about two-thirds of this bias, or about 0.7 percentage points. Keep in mind: This adds directly and fully to real GDP and productivity growth.

Even more important in this respect, though, have been the revisions in the price index for computers, about which we have recurrently reported, leading to the introduction of the so-called hedonic deflator for computers. According to Webster's, hedonic is “characteristic of pleasure.” In this instance, the introduction of the hedonic deflator was meant to capture the increases of computer power in terms of speed and memory. As we have also repeatedly described, this new method of measurement has rendered absolutely absurd results over time.

This index was, after long debate, introduced in 1986. But only since 1995 has it begun to exert a dramatic influence on the output statistics, owing to the furious increases in computer power and simultaneous decreases in computer prices. The most recent deflator has increased the computer sector's output growth by over 20 percentage points to a 70% annual rate, compared with unit and nominal output growth by perhaps 10%.

During the one-and-a-half years from end-1997 to mid-1999, business investment in computer hardware, measured in current dollars, was a mere \$ 24 billion, accounting for 3.3% of nominal GDP growth. But the “hedonic” deflator turned this trivial amount into pompous \$286 billion chained (1992) dollars, accounting for 55% of real GDP growth. Inherently, this correspondingly boosted productivity growth.

STATISTICAL MIRAGE

They must have realized that the difference between the two measurements of computer input was getting too ridiculous. The "Comprehensive benchmark revision" of last October, involving moreover a change in the reference year for chained dollars from 1992 to 1996, implemented a sweeping statistical change in this GDP component. On the one hand, computer software has been elevated from an intermediate business expense (which adds nothing to GDP growth) to a business fixed investment (which adds to GDP growth). The net effect of the revisions is that new and old computer figures are no longer comparable. It's like completely new statistics.

Cutting a complicated story short: According to the revised statistics, business spending on computers increased from the fourth quarter of 1998 to the fourth quarter of 1999 by \$13.2 billion to \$103 billion, accounting for a negligible 2.3% of GDP growth in current dollars. Software expenditure rose \$20 billion to \$151 billion. In new (1996) chained (phantom) dollars, however, the increase in business spending on hardware translates into \$70 billion, accounting for 19% of real GDP growth, and on software into \$18 billion, accounting for 5% of real GDP growth. Keep in mind again: This adds directly and fully to real GDP and productivity growth.

Sorry for these boring, statistical details, but these details really make all the difference between existence and non-existence of a new paradigm economy. Could there be flaws in our calculations and considerations? Frankly speaking, these findings are so appalling and so unbelievable that we hardly trust our eyes. But there are too many things in the American statistics that simply don't square.

All in all, we have to conclude that the alleged productivity miracle and the whole of the new paradigm economy are nothing but a statistical mirage. As a statistical procedure, by the way, this is unique among all countries.

It was recently announced that hedonic price deflators will also be introduced for audio and video equipment and that the applications to further classes of goods are being developed. This will further reduce measures of inflation and further increase real output and productivity growth. U.S. economic data will become ever less comparable to those of other economies.

There is still another question high-up in our mind: Who is aware that virtually all of the improvements in the productivity growth that everybody extols as the great miracle is derived largely, if not fully from statistical changes? Who in the government sector, who in particular in the markets? Mr. Greenspan is unquestionably one person who knows the full scope of these statistical influences. Yet he chooses to be a cheerleader of the "New Era."

Assessing the U.S. economy's performance, some other details appear worth mentioning: a growth rate in real GDP of 6.9% is inspiring news. But as usual, nobody bothered about the details of composition, such as the fact that government spending, chiefly national defense (Kosovo!), had contributed 1.61 percentage points or fully 23.3% to that GDP increase. Nor did anyone mention that 1.33 percentage points (or 19.3%) of that growth resulted from higher inventories. Together these two components accounted for 43% of the total growth.

WEAK SPOTS

Taking a closer look at the GDP numbers, all in chained (1996) dollars, we register various other weak spots that are completely ignored: *first*, residential building has now for one full year virtually stagnated. There is rampant inflation in this sector, but only in house prices, not in building; *second*, industrial and commercial building have been shrinking for more than a year; *third*, private fixed investment has been very weak in the fourth quarter contributing only 0.39 percentage points to GDP growth, compared with 1.10 percentage points in the year as a whole and 1.9 percentage points in 1998; *fourth*, sales of computers to businesses and consumers in the fourth quarter were at their lowest level in years: 0.15 percentage points of GDP growth, compared with

47 and 40 percentage points in 1998 and 1999; *fifth*, industrial and office equipment excluding computers increased in the course of last year by only 2%.

The unappreciated fact is that the U.S. economy is racing ahead on one single wheel: consumer spending powered by a blend of unprecedented stock market gains and a runaway borrowing binge. Of last year's real GDP growth, personal consumption expenditures provided no less than 87.5%, as against a long-term average of 66%. Taking two major distortions of the investment component into account, this ratio may well be around 100% of GDP and higher. These two distortions are, *first*, the phony hedonic deflator virtually quintupling computer investment in real terms and, *second*, heavy leasing of consumer durable goods appearing in the GDP statistics not as consumer spending, but as fixed investment of the financial sector.

Fortunately or unfortunately, a rapidly rising share of that borrowing and spending excess is hemorrhaging abroad to foreign producers, as reflected in the trade deficit that has ballooned from \$232 billion in the fourth quarter of 1998 to \$356 billion in the fourth quarter of 1999. A comparison of this stunning increase by \$154 billion with an increase in real GDP by \$367 billion highlights the monstrosity of this imbalance. The most conspicuous evidence of this soaring imbalance between domestic spending and domestic output is the rapidly widening gap between retail sales which, year-over-year, are up in volume by 8%, as against a 2% rise in industrial production (excluding computers and office equipment).

Is this truly a booming economy? It is above all an economy completely out of balance. While GDP in the aggregate appears to be booming, there is stagnation and even decline in important parts of this total. Most remarkable and most astonishing in this respect, as already mentioned, is the weakness in all categories of building and industrial equipment. It tells us that fixed investment in the New Economy has become sluggish, except in information processing and computers. In a full-employment economy, this weakness in fixed investment is the direct counterpart to the rampant boom in consumer spending. Consumer borrowing, just like government borrowing, essentially crowds out investment. This pronounced shift in the GDP composition toward private consumption is, by the way, another feature that eerily parallels what happened in the late 1920s.

PROFITLESS PROSPERITY

A compelling reason to doubt the accuracy of the stellar productivity figures in particular is the U.S. economy's poor profit performance in recent years. As the following table shows, profits of domestic, non-financial industries have been stagnant since the third quarter of 1997. Most remarkable (though in face of the strong dollar and the exploding trade deficit hardly astonishing) it is the sharp decline of profits in the manufacturing sector.

These hard facts about profits certainly fly in the face of the euphoric profit perception entertained on Wall Street. But they are simply ignored. As we have recurrently noted, information is more than abundantly available, but the desire for information is both very limited and highly selective. Just think of the Wall Street charade with expected profits or whisper numbers. This comparison is so senseless and so utterly ridiculous that you have to wonder how much stupidity it requires to seriously participate in this game that never seems to run out of junk to talk about.

What's more, profit quality is also going downhill. A trawl through recent earnings releases shows that more and more companies are supplementing their profits with stock market windfalls and financial transactions to astonishing levels. In the case of Microsoft, investment income has accounted for 21% of profits and more than two-thirds of profit growth. Intel, Delta Airlines and American Online all reported substantial gains from selling equity stakes. The \$596 million Delta garnered from unloading part of its holding in international ticket seller Priceline.com was more than three times the \$175 million it made from flying airplanes. Chase Manhattan's

private equity arm contributed \$1.3 billion - more than 40% of the bank's entire fourth-quarter earnings.

This, too, is not at all astonishing. It belongs to the essence of the new American model. Given the enormous pressure that managers of Corporate America are under to deliver regular double-digit earnings increases, there must be desperation to bolster profits with any accounting trick and financial gains possible - even though the accounting rules demand breaking down financial gains in the footnotes to their results statements. But readiness of the analysts to ignore such footnotes is assured.

UNITED STATES: CORPORATE PROFITS BY INDUSTRY (BILLIONS OF DOLLARS)						
	<u>1987</u>	<u>1990</u>	<u>1995</u>	<u>1997*</u>	<u>1998</u>	<u>1999**</u>
Domestic Industries	250.4	315.9	558.2	717.3	702.8	719.0
Nonfinancial	193.3	224.3	403.8	530.7	511.5	515.1
Manufacturing	83.1	109.2	166.1	195.4	168.4	163.1
Durable goods	39.3	41.6	77.6	104.4	95.1	94.4
Electronic	5.6	8.4	21.4	24.4	18.2	20.8
Nondurable goods	43.8	67.6	88.5	91.1	73.3	68.7
Transportation	42.0	44.4	85.8	108.2	109.0	117.3
Retail trade	23.4	21.0	44.1	66.1	69.8	67.7

* third quarter of 1997 ** third quarter of 1999
Source: Department of Commerce, Survey of Current Business

Looking at this poor profit development since 1997, it appears that it requires inquiry, why even with its great new paradigm qualities, is the U.S. economy is virtually profitless? Symptomatic again of the prevailing complacency and lacking macroeconomic research, nobody even poses, let alone investigates, this important question. If corporate earnings stagnate even under present boom conditions, what is going to happen to profits when the economy slows down?

ELUSIVE HIGH TECH PROFITS

After careful consideration, we see three major causes squeezing corporate profits in America. *First*, the soaring trade deficit; *second*, the statistical fudge; and *third*, new high tech.

The most obvious profit killer is the soaring U.S. trade deficit. To understand its role in this respect, two things have to be considered: *first*, that a large part of the money purchasing foreign goods does come from the domestic wage bill, in other words, from business expenses, and *second*, that the spending on imported goods involves corresponding loss in revenues for American businesses. Net result of such a huge trade deficit is essentially a massive profit squeeze.

The second major reason for the U.S. economy's poor profit performance is the pervasive, statistical fudge that we have described in some detail. As expounded, all those downward revisions of inflation rates and deflators undertaken in past years have substantially bolstered real GDP growth in terms of (1996) chained dollars. By force of sheer arithmetic, this to productivity growth. But while these phantom dollars have greatly improved the look of these two statistical aggregates, they don't add one single penny to profits and cash flow, which are measured in old-fashioned current dollars.

Now to the third major factor adversely impacting the profit trend in the U.S. economy: certain financial peculiarities of the new information technology. Considering the big losses that numerous high tech firms are producing, these implicitly depress overall profits. The pertinent question, then, is whether and when the predicted and expected big profits of the high sector will materialize. As we shall explain: never.

Market lore has it that, for various reasons, high tech firms have infinite profit prospects. The popular

arguments are explosive growth, a small capital base and no costly investments like conventional firms. Above all, there are no bricks and mortar to be acquired at high fixed costs. In contrast, a new era firm can expand infinitely with little fixed costs. All it has to do is to borrow and spend to grab a rising market share and to enjoy the increasing returns that will come with scaling up. So far, however, it has become rather more the rule that the faster the rise in sales, the faster the rise in losses. As greater market shares explicitly take precedence over greater profits, investors readily line up for the privilege of transferring more of their wealth to the customers of Amazon.com and the like. Then they reward themselves by bidding up the share price.

BURNING CASH AND CAPITAL

The stupidity of this system simply defies imagination. What is overlooked are the important differences between the cost structures of the new and old economy, on which profitability depends. True, conventional firms generally face large upfront costs in acquiring the physical plant and equipment to produce or to sell their goods. But these expenditures enter corporate accounting not as business expense, but as investment spending for asset creation that is capitalized. No business expense is incurred until in the following year, when the first depreciation charge is recorded.

Now compare this investment and cost pattern of firms in the old economy with those in cyberspace. Yes, they have the advantage that they can start with minimal capital expenditures compared to the firms in the brick and mortar world, but that is more than offset by the tremendous disadvantage in their exposure to current costs. In order to get attention and draw customers, they are drowning each other in advertising and marketing costs, which can only rise and rise as more and more firms will join the competition. Instead of creating new capital assets, they run ever higher current costs, virtually burning their cash and their capital. Far from improving, the profit and loss accounts of most firms show progressive deterioration, and we see nothing but reasons why loss-making will remain the habit of most companies.

Note that high rates of fixed investment have been the largest and most important source of aggregate profits in the Industrial Revolution because these capital expenditures - from a macro perspective - generate business sector revenue without generating immediate business expense. There is a widespread view that the Information Revolution will create far greater profits because it involves very little capital expenditures. Though it may seem paradoxical, this very fact is precisely what tends to make for low profitability.

Apparently, it is the explosive growth rates of the high tech sector in particular that have captivated investors. But much of these steep rates of growth are an optical illusion owing to the extremely low base from which the measuring has started. Penetration of potential markets, on the other hand, is rising so fast that the number of years until virtual saturation can generally be counted on the fingers of one hand. There is finite growth potential but infinite competition.

WHY A CRASH?

Where does it end? People ask, why must it end in a crash, why not in a soft landing of the markets and the economy, if Mr. Greenspan acts very quickly? In this respect, too, we share the point of view of the old economists, particularly emphasized by the Austrian school, that the decisive causes of a crash and crisis and also of their severity must be sought not in the policies applied after the crisis has started, but in the scale of the excesses and imbalances that developed during the preceding boom.

This view has always been a great bone of contention between American and Continental European economists, for two reasons. The one is the refusal of most American economists to recognize and to understand the notion of unsustainable imbalances and dislocations imparted by the credit excesses to the demand and output structures which the European economists regard as the most dangerous effects of credit inflation, far

more dangerous than any effects on the inflation rates. And the second reason is that most American economists believe in the omnipotence of central banks to prevent a crisis under all circumstances.

Not every bull market needs to end in a crash. Whether or not a crash is inevitable depends on the scale of excesses in the markets and the scale of imbalances and dislocations they have imparted to the economy. America's stock market bubble is of a magnitude without precedent in history. More importantly, it encompasses the entire economy. Its effects on the economy are so vast, so pervasive and so ingrained that when the bubble bursts, there will be trouble in almost every corner of the economy and the financial system. When and how traumatically are the only questions.

It is our long-held view that Mr. Greenspan will hold his money spigots wide open. But instead of avoiding the crisis, this policy can only worsen it by fueling ever greater excesses. What principally makes a bust of a bubble inevitable is simply the fact that it needs ever larger credit injections just to maintain the thrust in the markets and the economy. Even god Greenspan is unable to deliver this. Mere failure to accelerate is enough to finish the boom.

In 1996, the U.S. stock market and the economy boomed with credit growth of \$1,300 billion. In 1997, it was \$1,700 billion; in 1998, it accelerated to \$2,100 billion in 1998, but in 1999, it was only \$2,100 billion in 1999. Though ludicrously high in absolute terms, the latter figures meant a drastic deceleration in the pace of credit growth. The same \$2.1 trillion in new credit that had in 1998 lifted the whole market sharply higher, were in 1999 only sufficient to push a small number of high tech stocks higher.

But what is it that suggests not just a market crash but also a prolonged, severe economic and financial crisis in the United States? There are various causes, but the most important one is the great financial vulnerability of the consumer who, taken as a whole, has recklessly ravaged his finances by slashing his liquidity to a record-low while boosting his indebtedness to ever new highs.

A widespread complacent and comforting view has it that the enormous rise in household wealth makes the consumer and the economy resilient to negative shocks. However, precisely the opposite is true. Any concerted attempt to convert illiquid stock holdings into cash will merely depress stock prices, destroying market liquidity. Typically, market liquidity vanishes overnight, and as people begin to realize the futility of their attempts to raise liquidity over time, the selling turns into a stampede and panic. That's how every bubble has ended and this is bound to end.

American households have 56% of their financial assets tied to the stock market now, compared with 28% in 1989. Mortgage debt now equals 43% of the value of owner-occupied housing, compared with 30% in 1985. In particular, margin debt has risen by 62%, or almost \$90 billion over the past year alone. But now comes the hammer: in a balance sheet of more than \$30,000 billion, liquid assets in the form of bank deposits amount to less than \$4,000. In short, the collective balance sheet of the American consumer is extremely illiquid.

What this gross disproportion between cash balances and stockholdings reflects is extreme bullishness toward securities associated with minimal demand for money and liquidity. We guess this unusually low liquidity of private households has to do with unbridled confidence in Chairman Greenspan's openly declared resolve and promise that he stands ready to act quickly and forcefully if financial turbulence threatens to destabilize the economy, as he did in the autumn of 1998. No less high-flying seems the general belief that he is the man who will infallibly prevent anything really bad from happening. The result: minimum liquidity and maximal financial leverage and indebtedness.

U.S. CREDIT MACHINE IN TROUBLE

Recent events intimate that the Great U.S. Credit machine is in serious trouble after having in the fourth quarter of last year produced its worst ever excesses. The chief signs of the unfolding troubles is the inversion

of the yields curve between long-term and short-term bonds and rapidly widening spreads between U.S. Treasuries and corporate and mortgage bonds.

It appears that the mortgage security marketplace is the key source of current systemic stress. The spread between generic Fannie Mae mortgage-backed securities and 10-year Treasury notes has widened to 161 basis points, after trading at 124 basis points on Jan. 26th. Elsewhere, speculators who had bet on a steeper yield curve have been severely blooded. The spread between 5-year notes and 30-year Treasury bonds now exceeds a negative 50 basis points, after a positive 12 basis points in mid-January. An even greater debacle, however, has developed for those speculators financing or hedging mortgages with the government long bond. This spread has widened almost 60 basis points since mid-January to 194.

The harsh reality remains that the highly leveraged U.S. financial system functions poorly with any widening of spreads. As was the case during the LTCM fiasco, this abruptly leads to illiquid markets as the leveraged players are forced to dump securities and frenetically move to hedge risk. Putting it as simple as possible: The world's greatest and leading financial system is vulnerable in the extreme because it is built on rampant leverage and a trickle of savings.

CONCLUSIONS:

Gambling on high tech productivity miracles, Mr. Greenspan has squandered the chance of a soft landing for the U.S. economy by keeping the money and credit spigots wide open far too long. The "new paradigm" is, in any case, mostly statistical fiction.

Recent very strong GDP numbers, reflecting surges in government spending and inventories, give a grossly distorted picture of U.S. economic health and strength. Fixed investment has been weak across the board. The capital-gains-induced consumer borrowing and spending binge has become the economy's sole driving force.

Worldwide, more than 90% of all stocks are sliding at an accelerated speed. Even in the high tech sector, many major stocks have suffered steep losses. Most importantly, the ongoing world economic recovery prevents central banks from coming again to the rescue of the markets, if the decline escalates.

Don't mistake global economic recovery for global strength and stability. The world economy depends excessively on the U.S. consumer borrowing and spending binge and rampant international credit expansion. In the 1997 crisis, Rubin-Greenspan orchestrated the rescue of a crisis-ridden Asia and Russia. There is nobody to orchestrate the rescue of a crisis-ridden America. Trouble in the United States would quickly be transmitted around the world.

Risks now vastly outweigh profit chances in the stock markets.

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